2.2 PARTNERSHIP ACCOUNTS

2.2.1 Basic concept of Partnership

A business can be organized in the form of a sole proprietorship, a partnership firm, or a company. The sole proprietorship has its limitations such as limited capital, limited managerial ability and limited risk bearing capacity. Hence, when a business expands or when it is to be set up on a scale, which needs more capital and involves more risk, two or more persons join hands to run it. They agree to share the capital, the management, the risk and profits of the business. Such mutual economic relationship based on a written or an oral agreement amongst these persons is termed as '**partnership**'. The persons who have entered into partnership are individually known as '**partners**' and collectively as '**firm**'.

The Indian Partnership Act, 1932, Section 4, defined partnership as "the relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all".

According to J. L. Hanson, "a partnership is a form of business organization in which two or more persons up to a maximum of twenty join together to undertake some form of business activity".

Thus we can define partnership as an association of two or more persons who have agreed to share the profits of a business which they run together. This business may be carried on by all or anyone of them acting for all.

Features of Partnership

More Persons : As against proprietorship, there should be at least two person's subject to a maximum of ten persons for banking business and twenty for non-banking business to form a partnership firm.

Profit and Loss Sharing : There is an agreement among the partners to share the profits earned and losses incurred in partnership business.

Contractual Relationship : Partnership is formed by an agreement-oral or written-among the partners.

Existence of Lawful Business : Partnership is formed to carry on some lawful business and share its profits or losses. If the purpose is to carry some charitable works, for example, it is not regarded as partnership.

Utmost Good Faith and Honesty : A partnership business solely rests on utmost good faith and trust among the partners.

Unlimited Liability : Like proprietorship, each partner has unlimited liability in the firm. This means that if the assets of the partnership firm fall short to meet the firm's obligations, the partners' private assets will also be used for the purpose.

Restrictions on Transfer of Share : No partner can transfer his share to any outside person without seeking the consent of all other partners.

Principal-Agent Relationship : The partnership firm may be carried on by all partners or any of them acting for all. While dealing with firm's transactions, each partner is entitled to represent the firm and other partners. In this way, a partner is an agent of the firm and of the other partners.

Partnership Deed

A partnership Deed is formed by an agreement. This agreement may be written or oral. Though the law does not expressly require that there should be an agreement in writing but the absence of a written agreement may be a source of trouble in managing the affairs of the partnership firm. Therefore, a partnership deed should be written, assented and signed by all the partners.

Contents of Partnership Deed

The partnership deed usually contains the following particulars :

- Name of the firm;
- Names and addresses of all partners;
- Nature and place of the business;
- Date of commencement of partnership;
- Duration of partnership, if any;
- Amount of capital contributed or to be contributed by each partner;
- Rules regarding operation of bank accounts;
- Ratio in which profits are to be shared;
- Interest, if any, on partners' capital and drawings
- Interest on loan by the partner(s) to the firm;
- Salaries, commissions, etc. if payable to any partner(s);
- The safe custody of the books of accounts and other documents of the firm;
- Mode of auditor's appointment, if any;
- Rules to be followed in case of admission, retirement, death, of a partner;
- Settlement of accounts on dissolution of the firm; and
- Mode of settlement of disputes among the partners

Provision affecting accounting treatment in absence of partnership deed.

- **Profit Sharing :** Profit and Loss should be shared equally among all partners.
- **Remuneration :** No Remuneration is allowed to any partner.
- **Interest on Capital :** No Interest on capital is allowed to any partner
- **Interest on Drawings :** No Interest on drawing is changed by any partner.
- **Interest on Loans or Advance :** Interest on Loans and Advance are allowed to partner @ 6% per annum.

Kinds of Partner

- **Active Partner :** The partner who has invested more in partnership business and directly involves in business activities is called active partner. They take all responsibility of business, he/she bears unlimited liability, share the profit of business and devoted full time to the business. For the full-time involvement, active partners receive remuneration and for the investment, he will receive the share of profits.
- **Sleeping Partner :** The partners who have invested money but don't involve in business activity is called sleeping partner. A sleeping partner bears the loss of business, has unlimited liability and takes all other responsibility as like active partner but he/she is not directly involved in business activities.
- **Nominal Partner :** The partner who has not invested money but nominated as a partner is called nominal partner. It doesn't bear any risk or loss of business. It is a special kind of partners who is nominated as a partner because of his reputation in society.
- **Quasi Partner :** The partner who is retired from business but investment is not returned is called quasi-partner. This partner is neither liable for business activity nor has right over the profit of business after retirement.
- **Limited Partner :** The partner whose liability is limited to his investment only is called limited liability. As like the active partner, limited liability partner shares profit, invest money and participate in business but the difference is that limited partners do not have unlimited liability as an active partner.

- **Minor Partner :** The partner below the age of 16 years age is called minor partner. They are not allowed to sign the legal document of business because of this he can be a partner only under the guardianship of another partner.
- **Sub Partner :** The partner who shares the profit of business with other partners is called sub-partners. It has co-investment (joint investment) with other partners. This is made with mutual agreement and understanding with other partners. There profits and loss of business are share by sub-partners according to agreements made internally by partners.
- **Incoming Partner :** The partners who are going to newly enter in business is called incoming partners. The incoming partner is required to pay the premium amount to be a partner of existence business. The agreement between existence partners is required to enter a new partner.
- **Outgoing Partner :** The partner who is going to retire from business is called outgoing partner. The outgoing partner can retire from the business by making an agreement with other partners. He can retire by selling his share to other partners or outside parties in the consent of existing partner. The outgoing partner is not liable for future liabilities of the partnership.
- **Holding out - Estoppel Partners :** The partner who represents himself as a partner but does not invest money in business is called holding out or estoppel partners. He is a partner only in the eye of law or creditors. This partner doesn't share profits and does not bear loss as well. Therefore, he has not any liability of the business.
- **Secret Partners :** A Partners who invests money in the business and shares profit and losses but he doesn't like to be disclosed as a partner in front of the public is called secret partners. He provides all necessary helps assistant to business indirectly.

Partnership of Accounts

- Maintenance of capital accounts of partners;
- Ascertainment and allocation of profit and losses;
- Adjustment for wrong allocation of profits and losses;
- Allocation of profits involving minimum guaranteed profit to a partner;
- Reconstitution of the partnership firm; and
- Dissolution of the firm.

Partners' Capital Accounts

There are two methods by which the capital accounts of partners can be maintained. These are :

- Fluctuating Capital Method; and
- Fixed Capital Method.

Fluctuating Capital Method : Under the fluctuating capital method, only one account viz., the capital account for each partner, is maintained.

Dr.							Cr.
Date	**Particulars**	**J..F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount**
	Drawings Interest on Drawings Share of loss Withdrawal of capital Closing balance		xxxxx		Opening balance Addition to capital Interest on capital Salary Commission/Bonus Share of profit		
	Total				**Total**		

Note : A Partners' Capital Account usually shows a credit balance. It can, however, show a debit balance under certain circumstances, such as over withdrawal or insolvency of the partner.

Fixed Capital Method : under fixed capital method, two accounts are maintained for each partner viz.,

(i) Capital Account and

(ii) Current Account

Partners' Capital Account

Dr.	Partners' Capital Account						Cr.
Date	**Particulars**	**J.F.**	**Amount Rs.**	**Date**	**Particulars**	**J.F.**	**Amount Rs.**
	Withdrawal of capital Closing balance				Opening balance Addition to capital		
	Total				**Total**		

Dr.	Partners' Current						Cr.
Date	**Particulars**	**J..F.**	**Amount Rs.**	**Date**	**Particulars**	**J.F.**	**Amount Rs.**
	Opening Balance* Drawings Interest on Drawings Share of loss Withdrawal of capital Closing balance		xxxxx		Opening balance* Addition to capital Interest on capital Salary Commission/Bonus Share of profit		
	Total				**Total**		

In Partners' Current Account, opening balance and closing balance may appear on either side, i.e. debit or credit.

Distribution of Profit

In case of partnership firm, the net profit (after charging the interest on capital, partners' salary and commission and after taking into account the interest on drawings) is to be shared by all the partners in the agreed profit sharing ratio. As stated earlier, in the absence of any specific agreement to this effect, the profit is to be distributed equally among the various partners

Profit and Loss Appropriation Account

As stated above, the net profit as shown by the profit and loss account of a partnership firm needs certain adjustments with regarding to interest on capitals, interest on drawings, salary, commission to the partners, if provided, under the agreement. For this purpose, 'Profit and Loss Appropriation Account' may be prepared.

For preparing the profit and loss appropriation account, the following journal entries have to be recorded for various items :

1. For Interest on Capital :

(i) For Crediting Interest on Capital to Capital/Current Account :

Interest on Capital a/c Dr.

To Partners' Capital/Current a/c

(ii) For transferring Interest on Capital to Profit and Loss Appropriation Account:

Profit and Loss Appropriation a/c Dr.

To Interest on Capital a/c

2. For Interest on Drawings :

(i) Interest on Drawings is a gain to the firm and is charged to Partner's Capital/Current Account:

Partners' Capital/Current a/c Dr.

To Interest on Drawings a/c

(ii) For transferring Interest on Drawings to Profit and Loss Appropriation Account, the following entry is to be recorded:

Interest on Drawings a/c Dr.

To Profit and Loss Appropriation a/c

3. Partner's Salary :

(i) Salary allowed to a partner is a gain of the individual partner and charge against the profits of the firm as per partnership agreement. For this following entry is recorded:

Salary to Partner a/c Dr.

To Partner Capital/Current a/c

(ii) For charging salary allowed to a partner:

Profit and Loss Appropriation a/c Dr.

To Salary to partner a/c

4. Partner's Commission :

(i) Commission is an expense for the firm and a gain to the partner. For this, following entry is made:

Commission to partner a/c Dr.

To Partner's capital/current a/c

(ii) Commission paid to a partner is charged to Profit and Loss Appropriation account by recording the following entry:

Profit and Loss Appropriation a/c Dr.

To Commission to partners a/c

5. For Transfer to Reserve :

Profit and Loss Appropriation a/c Dr.

To Reserve

6. For share of Profit or Loss on Appropriation :

If Profit :

Profit and Loss Appropriation a/c Dr.

To Partner's Capital/Current a/c

If Loss :

Partner's Capital/Current a/c Dr.

To Profit and Loss Appropriation a/c

Dr.	Profit and Loss Appropriation Account						Cr.
Date	**Particulars**	**J..F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount**
	Net Loss as per Profit and Loss A/c Interest on Capital A XX B XX Partner's Salary Partner's Commission Reserve (transfer) Capital A/cs –Share of profit (if profit) A XX B XX		Xxx		Net profit as per Profit and Loss A/c (if profit) Interest on drawings A XX B XX Capital A/cs Share of loss (if loss) A XX B XX		
	Total				**Total**		

2.2.2 Admission of New Partner

According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon

On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio

(ii) Adjustment of Goodwill

(iii) Adjustment for revaluation of assets and reassessment of liabilities

(iv) Distribution of accumulated profits and reserves

(v) Adjustment of partners' capitals.

Adjustment in Profit Sharing Ratio

At the time of admission of the new partner into the firm there is a need to calculate the new profit sharing ratio of the firm.

There are different cases for the calculation of new ratio:

Case-1 : When only the share of new partner is given in the question

In this case it is assumed that the old partners will continue to share the remaining profits in the same ratio in which they were sharing before the admission of the new partner.

Ex. A and B are partners in the ratio 2:3. They admitted C into the partnership with 1/4th share. Calculate the new profit sharing ratio of the firm.

Sol. Let total profits = 1

Share = 1/4

Remaining share = 1 – 1/4 = 3/4

A's share = 2/5 of 3/4 = 6/20

B's share = 3/5 of 3/4 = 9/20

C's share = 1/4 = 5/20

Thus the new ratio among A, B and C is 6/20 : 9/20 : 5/20 i.e. 6 : 9 : 5.

Case-2 : When the new partner purchases his share form the old partners

In this case we deduct the share given to the new partner by the old partners to get their new share and calculate their new ratio.

Ex. X and Y are partners in the ratio 2:1. They admit Z into the firm with 3/7th share which he gets 2/7 from X and 1/7 from Y. Calculate the new profit sharing ratio.

Sol. X's old share = 2/3

X's sacrifice for Z = 2/7

X's new share = 2/3 – 2/7 = 8/21

Y's old share = 1/3

Y's sacrifice for Z = 1/7

Y's new share = 1/3 – 1/7 = 4/21

Z's share = 3/7 = 2/7 + 1/7 = 3/7 = 9/21

New Profit sharing Ratio among X, Y and Z is 8 : 4 : 9

Case-3 : When old partners surrender a particular fraction of their share in favour of new partner

In this case first calculate the share surrendered by old partners in favour of new partner. From the old share of old partners, subtract their surrendered share to get their new share. Now add share surrendered by old partners to get the share of new partner.

Ex. X and Y are Partners sharing profits and losses in the ratio 2:1. They admit Z into the firm. X surrenders 1/4th of his share and Y surrenders 3/4th of his share in favour of Z. Calculate their new profit sharing ratio.

Sol. X's old share= 2/3

Share surrendered in favour of Z = 2/3 × 1/4 = 1/6

X's new share = 2/3 – 1/6 = 3/6

Y's old share= 1/3 Share surrendered in favour of Z = 1/3×3/4 = 1/4

Y's new share = 1/3 × 1/4 = 1/12

Z's share = 1/6 + 1/4 = 5/12

New Profit Sharing Ratio among X, Y and Z is 3/6 : 1/12 : 5/12 i.e. 6 : 1 : 5

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in the favour of the new partner.

Sacrificing Ratio = Existing Ratio – New Ratio

Case-1 : Only the new partner's share is given

Ex. Raj and Amit are partners sharing profit in the ratio of 3 : 2. They admit Naman as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Sol. Calculation of new profit sharing ratio:

Let total Profit = 1

New partner's share = 1/5

Remaining share = 1 – 1/5 = 4/5

Raj 's new share = 3/5 of 4/5 i.e. 12/25

Amit's new share = 2/5 of 4/5 i.e. 8/25

Naman's Share = 1/5

The new profit sharing ratio of Raj, Amit and Naman is :

= 12/25 : 8/25 : 1/5

= 12 : 8 : 5/25

= 12 : 8 : 5

So Raj Sacrificed = 3/5 – 12/25 = 15 – 12/25 = 3/25

Amit Sacrificed = 2/5 – 8/25 = 10 – 8/25 = 2/25

Sacrificing Ratio = 3 : 2

Case-2 Sacrificing ratio of the existing partners is same as their existing ratio.

The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

Ex. Ram and Laxman are partners, sharing profit in the ratio of 5 : 3. They admit Baharat as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Ram and 1/24 share from Laxman. Calculate the new profit sharing ratio and sacrificing ratio.

Sol. Ram's and Parteek existing ratio is 5 : 3

Ram's new share = 5/8 – 1/8 = 4/8 or 12/24

Laxman 's new share = 3/8 – 1/24 = 8/24

Baharat's share = 1/8 + 1/24 = 4/24

The new profit sharing ratio of Ram, Laxman and Baharat is :

= 12/24 : 8/24 : 4/24

= 12 : 8 : 4

= 3 : 2 : 1

Sacrifice ratio = 1/8 : 1/24 or 3 : 1

Case-3 : Existing partners surrender a particular portion of their share in favour of a new partner

Ex. Him and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Him surrendered 1/5 of his share and Raj 1/3 of his share in favour of Jolly. Calculate the new profit sharing ratio.

Sol. Him surrenders 1/5 of his share, i.e., = 1/5 of 5/8 = 1/8

Raj surrenders 1/3 of his share, i.e., = 1/3 of 3/8 = 1/8

So, sacrificing ratio of Him and Raj is 1/8 : 1/8 or equal.

Him's new share = 5/8 – 1/8 = 4/8

and Raj's new share = 3/8 – 1/8 = 2/8

Jolly's New share = 1/8 + 1/8 = 2/8

New profit sharing ratio of Him's, Raj's and Jolly's is = 4/8 : 2/8 : 2/8

or 4 : 2 : 2 or 2 : 1 : 1

Adjustment of Goodwill

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as "goodwill".

In simple words, goodwill can be defined as "the present value of a firm's anticipated excess earnings" or as "the capitalised value attached to the differential profit capacity of a business". Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

Need for Valuation of Goodwill

Normally, the need for valuation of goodwill arises at the time of sale of a business. But, in the context of a partnership firm it may also arise in the following circumstances:

1. Change in the profit sharing ratio amongst the existing partners;
2. Admission of new partner;
3. Retirement of a partner;
4. Death of a partner; and
5. Dissolution of a firm involving sale of business as a going concern.
6. Amalgamation of partnership firms.

Treatment of Goodwill

There are different situations relating to treatment of goodwill at the time of admission of a new partner. These are discussed as under :

1. When the amount of goodwill is paid privately by the new partner.
2. When the new partner brings his/her share of goodwill in cash.
3. When the new partner does not bring his/her share of goodwill in cash.

1. The amount of goodwill is paid privately by the new partner : If the amount of goodwill is paid by the new partner to the existing partner privately, no journal entries are made in the books of the firm.

2. The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business : When, the new partner brings his/her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partner in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partner, it will be written off immediately in existing ratio among the partners.

The journal entries are as follows :

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as :

Existing Partners Capital A/c Dr. [individually]

To Goodwill A/c

(Existing goodwill written off)

(ii) For bringing cash for Capital and goodwill :

Cash/Bank A/c Dr.

To Goodwill A/c

To New partner's Capital A/c

(Cash brought in for capital and goodwill)

(iii) For amount of goodwill transferred to existing partner capital account:

Goodwill A/c Dr.

To Existing Partner's Capital/current A/c [individually]

(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)

The amount of goodwill is withdrawn by the existing partners:

(iv) The amount of goodwill is withdrawn by the existing partners :

Existing Partners Capital/current A/c Dr. [individually]

To Cash/Bank A/c

(The amount of goodwill withdrawn by the existing partners)

3. New partner does not bring his/her share of goodwill in cash : When the goodwill of the firm is calculated and the new partner is not able to bring his/her share of goodwill in cash, goodwill will be adjusted through new partner's capital accounts. In this case new partner's capital account is debited for his/her share of goodwill and the existing partner's capital accounts are credited in their sacrificing ratio. The journal entry is as under:

New Partner's Capital A/c Dr.

To Existing Partner's Capital A/c [individually in sacrificing ratio]

(New partner's share in goodwill credited to existing partner's in sacrificing ratio)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash:

If the goodwill account appears in the books of the firm and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

Hidden or Inferred Goodwill

Sometimes the value of goodwill is not given at the time of admission of a new partner. In such a situation, goodwill is calculated on the basis of net worth of the business. Hidden goodwill is the excess of desired total capital of the firm over the actual combined capital of all partners'.

For Example

Capital of L and M are Rs. 2,00,000 and Rs. 1,50,000 respectively. They admit N as a Partner for 1/5 share with Rs. 1,00,000 as his Capital.

On the basis of N's Capital, total Capital of the Firm should be Rs. 5,00,000 (1,00,000 × 5/1).

But the actual Capital of the Firm is Rs. 4,50,000 (2,00,000 +1,50,000 +1,00,000).

Hence, Hidden Goodwill: = Rs. 5,00,000 – Rs. 4,50,000 = Rs. 50,000

Revaluation of Assets and Reassessment of Liabilities

Accounting Entries		
(i)	For increase in the value of Assets	Assets A/c (Individually) . Dr. To Revaluation (or P & L Adjustment) A/C
(ii)	For a decrease in the value of Assets	Revaluation A/c ....Dr. To Assets A/c (Individually)
(iii)	For an increase in the amount of Liabilities	Revaluation A/c ....Dr. To Liabilities A/c (Individually)
(iv)	For a decrease in the amount of Liabilities	Liability A/c (Individually) ....Dr. To Revaluation A/c
(v)	For an accounting unrecorded Assets	Assets A/c (Individually) ....Dr. To Revaluation A/c
(vi)	For accounting unrecorded Liabilities	Revaluation A/c ....Dr. To Liability A/c (Individually)

Revaluation Account	
Particulars	**Particulars**
To Decrease in value of assets	To increase in value of liabilities .....
By Increase in value of assets	By Decrease in value of liabilities .....
To Unrecorded liabilities	By Unrecorded assets .....
To Profit transfer to the old Partner's	By Loss transfer to the old Partner's .....
Capital A/c s (in the old ratio)	Capital A/c s (in the old ratio) .....

Adjustment for Reserve and Accumulated Profit and Loss

Accounting Entries

(i) For transfer of Reserves and Accumulated Profits :

Profit and Loss ...Dr.

Reserve Fund A/c or General Reserve ...Dr.

Workmen Compensation Reserve ...Dr. [Excess of Reserve over Actual Liabilities]

Investment Fluctuation Reserve A/c ...Dr. [Excess of Reserve over the difference between Book Value and market Value]

To Old Partners' Capital A/c s [In old Ratio]

(Being the reserve and profit transferred to old partners in their old ratio)

(ii) For transfer of Reserves and Accumulated Losses :

Old Partners' Capital A/c s ...... Dr.

To Profit and Loss A/c [In old Ratio]

To Deferred Revenue Expenditure A/c

(Like Advertisement Expenditure)

(Being the accumulated losses transferred to old partners in their old ratio

Adjustment of Surplus/Deficiency through Cash

(a) If Capital of Old Partners falls short (Deficit), bring in cash :

Cash/Bank A/c ....Dr.

To Partners' Capital A/c s

(b) If capital of old partner has a surplus, withdraw cash :

Partners' Capital A/c....Dr.

To Cash/Bank A/c

Adjustment of Surplus/Deficiency through Partner's Current Account

(a) If the existing capital is more than his required capital (surplus)

Partner's Capital A/c ....Dr.

To Partner's Current A/c

(b) If the existing capital is less than his required capital (deficit)

Partner's Current A/c ....Dr.

To Partner's Capital A/c

If Current Account shows a Credit Balance, it is taken to the Liabilities side of the Balance Sheet. However, if Current Account shows a Debit Balance, it is placed on the Assets side of the Balance Sheet.

2.2.3 Retirement of Partner

When one or more partners leaves the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement, the retiring partner's claim is settled.

A partner retires either :

- With the consent of all partners, or
- As per terms of the agreement; or
- At his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. At the time of retirement, the following accounting issues are dealt.

(a) New profit sharing ratio and gaining ratio.

(b) Goodwill

(c) Adjustment of changes in the value of Assets and liabilities

(d) Treatment of reserve and accumulated profits.

(e) Settlement of retiring partners dues,

(f) New capital of the continuing partners.

New Profit Sharing Ratio and Gaining Ratio

The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio. It is

Gaining Ratio = New Ratio – Gaining Ratio

(i) Retiring partner's share distributed in Existing Ratio : In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio.

Ex. Tanu, Manu and Rena are partners sharing profits and losses in the ratio of = 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Sol. Existing Ratio between Manu and Rena = 3/9 and 2/9

Tanu's Ratio (retiring partner) = 4/9

Tanu's share taken by the Manu and Rena in the ratio of 3 : 2

Manu's gets = 4/9 × 3/5 = 12/45

Manu's New Share = 3/9 + 12/45 = 27/45

Rena's gets = 4/9 × 2/5 = 8/45

Rena's New Share = 2/9 + 8/45 = 18/45

New ratio between Manu and Rena is 27/45 : 18/45 = 27 : 18 = 3 : 2.

Gaining Ratio = New Ratio – Existing Ratio

Manu Gain = 27/45 – 3/9 = 12/45

Rena Gain = 18/45 – 2/9 = 8/45

12/45 : 8/45

3 : 2

(ii) Retiring partner's share distributed in Specified proportions : Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at.

Ex. A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

Sol. B's Share = 2/6

B's share is divided between A and C in the ratio of 1 : 1.

A gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6

A's New Share = 3/6 + 1/6 = 4/6

C's gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6

C's New share = 1/6+1/6 = 2/6

Gaining Ratio = New Ratio – Existing Ratio

Gain of A = 4/6 – 3/6 = 1/6

Gain of C = 2/6 – 1/6 = 1/6

1/6 : 1/6

1 : 1 i.e, equal

(iii) Retiring Partner’s share is taken by one of the partners : The retiring partner’s share is taken up by one of the remaining partners. In this case, the retiring partner’s share is added to that of partner’s existing share. Only his/her share changes. The other partners continue to share profit in the existing ratio.

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani’s share is 2/11 + 4/11 = 6/11, Anuj share will remain unchanged i.e, 5/11. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6

Valuation of Goodwill :

The valuation of goodwill may be done according to the provisions of the Partnership Deed and in the manner as in case of admission by any one of the following methods :

A.			
(i)	When goodwill is raised at its full value	Goodwill Account Dr. To All Partners' Capital A/c (Being goodwill raised at its full value and credited to all partners' capital account in old profit sharing ratio)	It appears in Balance Sheet
(ii)	When goodwill is raised and written off	Goodwill Account Dr. To All Partners' Capital A/c (Being goodwill raised at its full value and credited to all partners' capital account in old profit sharing ratio)	
		Continuing Partners Capital A/c To Goodwill Account (Being goodwill written off in new profit sharing ratio)	It does not appear in Balance Sheet
(iii)	When goodwill raised only to the extent of retiring partners' share.	Goodwill Account Dr. To Retiring Partners' Capital Account (Being goodwill raised to the extent of outgoing partners' share)	
		Continuing Partners’ Capital A/c Dr. To Goodwill Account (Being goodwill written off in gaining ratio)	It does not appear in Balance Sheet
(iv)	When goodwill is given to outgoing partner, without raising or recording it in the books	Continuing Partners’ Capital A/c Dr. To Outgoing Partners’ Capital Account (Being outgoing partners’ share of goodwill is credited to him and debited to continuing partners’ capital account in gaining ratio)	It does not appear in Balance Sheet
B. When goodwill already appears in the books			
(i)	If goodwill appears at correct value	No Entry	
(ii)	If goodwill appears at less value than the actual/present value	Goodwill Account Dr. To All Partners’ Capital A/c [Being goodwill raised in full value: only the difference (Old profit sharing ratio)]	It appears in Balance Sheet
(iii)	If goodwill appears at higher value than the actual value	All Partners’ Capital Account Dr. To Goodwill Account (Being the excess value of goodwill written off by debiting all partners’ capital accounts in old ratio)	It appears in Balance Sheet

Revaluation of Assets and Liabilities

At the time of retirement of a partner the assets and liabilities of the firm are revalued and Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any profit or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio.

Format of Revaluation Account			
Dr.	Revaluation Account		Cr.
Particulars	Amt (₹)	Particulars	Amt (₹)
To Decrease in Value of Assets	–	By Increase in Value of Assets	–
To Increase in Value of Liabilities	–	By Decrease in Value of Liabilites	–
To Unrecorded Liability	–	By Unrecorded Assets	–
To Profit Transferred to Old Partners' Capital/Current A/c (Old ratio)	–	By Loss Transferred to Old Partners' Capital/Current A/c (Old ratio)	–
	–		–

1. **For increase in value of assets :**
   Assets A/c Dr. [Individually]
   To Revaluation A/c
   (Increase in the value of assets)
2. **For decrease in value of assets :**
   Revaluation A/c Dr.
   To Assets A/c (Individually)
   (decrease in the value of asset)
3. **For increase in value of Liabilities :**
   Revaluation A/c Dr.
   To Liabilities A/c [Individually]
   (Increase in the value of liabilities)
4. **For decrease in value of Liabilities :**
   Liabilities A/c Dr. [Individually]
   To Revaluation A/c
   (decrease in the value of liabilities)
5. **For Profit on Revaluation :**
   Revaluation A/c Dr. (Individually)
   To Partner's Capital A/c
   (Profit on revaluation divided amongst all partners in their existing profit sharing ratio)
6. **For loss on Revaluation:**
   Partner's Capital A/c Dr. (Individually)
   To Revaluation A/c
   (Loss on revaluation borne by all partners in their existing profit sharing ratio)

If the continuing partners decide to maintain the assets and liabilities at their original value, then a **Memorandum Revaluation Account** is prepared by passing reversal entry and the profit or loss of this account is transferred to continuing partner's capital ac-count in their **New Profit Sharing ratio.**

Settlement of Retiring Partner Claim

1. Payment in Lump Sum : Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners. The following journal entry is made for disposal of-the amount payable to the retiring partner :

On payment of cash in lump sum.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

2. Payment in Installments : In this case the amount due to retiring partner is paid in installments. Usually, some amount is paid immediately on retirement and the balance is transferred to his loan account.

According to this rule, if the amount due to him is not paid immediately on his retirement, he can claim interest @ 6% p.a. on the amount due.

(i) On part payment in cash and balance transferred to his/her loan account.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) Total amount due transferred to loan A/c

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr.

To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) For payment of installment

Retiring Partners' Loan A/c Dr.

To Cash/Bank A/c

(Installment inclusive of interest paid)

Treatment Accumulated Reserve and Undistributed Profit

For Distribution of Distribution Profit and Reserve :

Reserves A/c Dr.

Profit and Loss (Profit) A/c Dr.

To Partner's Capital A/c

For Distribution of undistributed Loss

Partner's Capital A/c Dr.

To Profit and Loss (Loss)

Accounting treatment of Outgoing Partner share in Profit

A. Through Profit and Loss Suspense Account

(1) In case of Profit

Profit and Loss Suspense A/c Dr.

To Outgoing Partner's A/c

(New Profit Sharing Ratio)

(2) In case of Loss

Outgoing Partner's Capital A/c

To Profit and Loss Suspense A/c

B. Through Capital Transfer

(1) In case of Profit

Gaining Partner's Capital A/c

To Outgoing Partner's Capital A/c

(Gaining Ratio)

(2) In case of Loss

Outgoing Partner's Capital A/c Dr.

To Gaining Partner's Capital A/c

(Gaining Ratio)

2.2.4 Death of Partner

(a) When a partner dies his legal heir should be given :

1. His balance in Capital A/c and Current A/c
2. Share in past profits/losses
3. Share in Revaluation profit/ loss
4. Share in Goodwill
5. Interest on Capital up to the date of Death.
6. Salary up to date of death.
7. His share in profits up to the date of his death.
8. Share in Joint Life Policy.
   On death joint life policy will always mature.
9. Share in Individual Insurance Policy.

If individual life insurance policies have been taken on the life of the partners, then on the death of a partner his individual policy will mature and the individual policies of the other partners will be surrendered. All the partners get a share in the matured / surrendered individual policies.

(b) Deceased partner's share in profit to the date of his death is to be calculated on the basis of past profits.

$$\text{Share in Profit} = \text{Avg. Profit} \times \frac{\text{Number of months}}{12} \times \text{Profit share}$$

Calculation of profit up to the date of death of a partner.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods :

- Time Basis
- Turnover or Sales Basis

This profit is debited to P and L Suspense A/c and credited to Deceased Partner's Capital A/c. Profit and Loss Suspense A/c is to be shown in the Balance Sheet on the Asset side.

(c) Balance in Deceased Partner's Capital A/c is transferred to his Executor's Loan/Legal Loan A/c.

(d) In case any salary/interest on capital/interest on drawings is there, it should be given to the deceased partner from the Balance sheet date to the date of death.

Share in Profit

P and L Suspense A/c Dr.

To Deceased Partner's Cap. A/c

Transfer to Executor's Loan

Deceased Partner's Cap. A/c Dr

To Executor's Loan A/c

Joint Life Policy : A Joint Life Policy (JLP) is an insurance policy which is taken out by the partnership firm on the joint lives of all the partners. The amount of policy is payable by the Insurance Company either on the death or on maturity of policy, whichever is earlier. The firm pays annual premium to the insurer against the policy. Joint Life Policy will be an asset of the firm and deceased partner has a right to share any profit or loss on such policy. So, any claim which is received by the firm on the death of a partner is divided among the partners and credited to their capital accounts in their profit sharing ratio.

Accounting Treatment of Joint Life Policy

(A) Premium Paid is Treated as Expense :

1. The premiums are treated as expense and debited to P and L A/c

Insurance Premium A/c Dr

To Bank

(On payment of premium)

2. No Joint Life Policy Account is maintained.

Profit and Loss A/c Dr

To Insurance Premium A/c

(On premium charged to P and l A/c)

3. At the time of maturity of policy, the amount received will be credited to the capital accounts of all the partners (including the deceased partner) in their profit sharing ratio.

Insurance Company A/c Dr

To Partners' Capital A/c

(On maturity of policy)

4. Surrender value is not considered under this method.

Bank A/c Dr

To Insurance Company A/c

(On receipt of amount from the Insurance Co)

On B/f of the balance in JLP a/c:

Joint Life Policy A/c Dr

To All Partners' Capital A/c

(B) Premium Paid is Treated as an Asset :

1. Joint Life Policy is shown at its surrender value in the Balance Sheet

Joint Life Policy A/c Dr

To Bank A/c

(On payment of premium)

2. Surrender Value is the amount that the insurer would be willing to pay on the basis of number of premiums paid.

Profit and Loss A/c Dr

To Joint Life Policy A/c

(On t/f of balance exceeding surrender value)

At the end of the year, the amount which is in excess (i.e. Joint Life Policy A/c balance – Its surrender value) is transferred to the P/L A/c as a loss.

3. From the 2nd year and onwards, the 1st and 2nd entry shall be repeated until the last year. In the last year, i.e., the year of death, 1st entry will be recorded only if death takes place after the due date of premium and 2nd entry will not be recorded at all. On maturity of policy or in the event of death, the claim to be registered with the insurance company,

Insurance Company A/c Dr.

To Joint Life Policy A/c

(On maturity)

4. Joint Life Policy Account is maintained to which the premium paid shall be debited and the amount received from the insurance company shall be credited.

Bank A/c Dr.

To Insurance Company

(On receipt of amount from the Insurance Co.)

Joint Life Policy A/c Dr

To All Partners' Capital A/c

(On B/f of the balance in JLP a/c)

(C) Premium Paid is Treated as an Asset and Reserve is Maintained :

1. An amount equal to the premium is debited to the Profit and Loss Appropriation A/c and credited to the Joint Life Policy Reserve A/c

Joint Life Policy A/c Dr.

To Bank A/c

(On payment of premium)

Profit and Loss Appropriation A/c Dr.

To Joint Life Policy Reserve A/c

(On Appropriation of reserve)

2. The JLP A/c and the JLP Reserve A/c are mutually adjusted to leave in each account a balance equal to the surrender value of the policy.

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(On t/f of balance exceeding surrender value)

The entries for maturity of policy, receipt of the policy amount and t/f of balance in JLP A/c are same as above

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(On t/f of the balance in JLP Reserve A/c)

(D) Individual Life Insurance Policy : It is a life policy which covers the life of a partner individually On the retirement of a partner: Retiring partner entitled to his share in the surrender values of unmatured policies of all the partners on the date of retirement.

Note : Joint Life Policy Account is shown at the assets side of the Balance Sheet and the Joint Life Policy Reserve Account is shown at the liabilities side of the Balance Sheet.

Calculation of the Balance exceeding the Surrender Value

Annual Premium charged to the Profit and Loss A/c.

Add : Surrender Value of Policy in the previous year.

Less : Surrender Value of Policy in the current year.

= Balance exceeding the surrender value.

2.2.5 Dissolution of A Partnership Firm

Whenever a reconstitution takes place within a Partnership in the form of admission, retirement or death of a Partner, the existing partnership is dissolved. The Partnership firm, may however, continue, if the remaining partners desire so. But if the partnership firm is discontinued for any reason, that is called Dissolution of the firm. Dissolution of Firm – when does it take place [in accordance with the Indian Partnership Act of 1932]

1. By Mutual consent of all the partners or in accordance with a contract made by them [Section 40]
2. By Notice – given in writing, by any partner to all other partners if the Partnership is at will [Section 43].
3. On the happening of any one of the following events : [Section 42] :
   (i) Expiry of the term, where the Partnership was constituted for a fixed term;
   (ii) Completion of the adventure for which the firm was constituted;
   (iii) Death of a partner.
   (iv) Adjudication of a Partner as insolvent.
4. Compulsory Dissolution [Section 41] :
   (i) Where all the partners or all but one are adjudged insolvent.
   (ii) If any event occurs making it unlawful for the business of the firm to be carried on.
5. Dissolution by Court : According to Section 44 of the Indian Partnership Act the court, at the suit of a partner, may dissolve a firm on any one of the grounds namely :
   (i) Insanity of a partner;
   (ii) Permanent incapability of a partner to do his duties;
   (iii) If a partner is guilty of misconduct that might affect prejudicially the carrying on of the business;
   (iv) If a partner willfully or persistently commits breach of agreement;
   (v) If a partner transfers all his shares to a third party or has allowed his share to be charged under the Provisions of Rule 49 of order XXI of the First Schedule to the Code of Civil Procedure, 1908;
   (vi) If the court considers that the business cannot be carried on except at loss;
   (vii) On any other ground on which the court considers the dissolution as just and equitable.

Settlement of Accounts on Dissolution

According to Section 48 of the Indian Partnership Act the following rules should be observed for settlement of Accounts after dissolution, subject to agreement by partners :

(a) Regarding Losses : "Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly if necessary, by the partners individually in the proportions in which they are entitled to share profits". [Section 48(1)]

(b) Regarding Assets : "The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order :

(i) In paying the debts of the firm to third parties;

(ii) In paying each partner ratably what is due to him from the firm for advances as distinguished from capital;

(iii) In paying to each partner ratably what is due to him as capital; and

(iv) The residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits." [Section 48(2)]

Accounting Entries Regarding Dissolution

The two separate aspects of Dissolution for which accounting entries have to be made are :

(A) Realization of Assets and Payment of liabilities and

(B) Settlement of the dues of the Partners

(A) Realization of Assets and Payment of Liabilities :

(i) Prepare Realization Account

(ii) Transfer all assets (except cash, bank & fictitious assets) and liabilities at book values to Realization Account.

Journal Entries

	Item/Purpose	Entry		Special Points to be Noted
1	Transfer of book values of assets as recorded in the Balance Sheet	Realization A/c .... Dr. To Sundry Assets (Book value) (including goodwill if any, shown in the Balance Sheet) Realization A/c .... Dr. To Debtors A/c Provision for Bad Debts A/c .... Dr. To Realization A/c	(a) (b) (c)	Cash or Bank A/c are not to be credit unless the firm, as a whole is sold out as a going concern. Debit balance of any Cap. A/c etc. or Debit balance of P/L A/c not to be transferred to Realization A/c. If there is any Provision for bad Debts, debit Realization A/c and credit Debtors A/c with gross figure. Then debit Provision A/c and credit Realization A/c. Same treatment for Provision for Depreciation.
2	Realization/Sale of above assets	Cash/Bank A/c (amt. realized) .... Dr. or Partners Cap. A/c .... Dr. (agreed value at which a partner takes over an asset/assets) To Realization A/c.		
3	Shares etc. received as purchase consideration	In exchange of the firm's assets. Shares A/c .... Dr. To Realization A/c. (agreed value)		
4	Closing the External libilities	External Liabilities A/c .... Dr. (such as creditors, outsanding expenses, Bank Loan etc.) To Realization A/c. (book value)	(a) (b)	Alternatively-this entry may be passed (combining 4, 5 and 6) Liability A/c .... Dr. To Bank A/c (actual amt. paid) or To Partners Cap. A/c (agreed value) To Realization A/c (Discount, if any received on payment/discharge) Where assets and libilities are taken over by another business on making some lump sum payment, separate entries for realization of assets and / payment of libilities need not be made.
5	External liabilities paid off	Realization A/c .... Dr. To Cash/Bank A/c (actual amt. paid)		
6	External liabilities taken over by any partner	Realization A/c .... Dr. To Particular Partner's Cap. A/c (agreed value)		
7	Unrecorded asset sold or taken over by any partner	Cash/Bank A/c .... Dr. Partners Capital A/c .... Dr. To Realisation A/c		

8	If any unrecorded liability is paid	Realization A/c .... Dr. To Cash/Bank A/c (actual amt.)	
9	If shares etc. received and shown in (3) above are sold out or transferred to partners.	Cash/Bank A/c .... Dr. or Partners Cap. A/c .... Dr. (excluding insolvent partner) To shares A/c.	For sale, there may be profit or loss on sale which is transferred to Realization A/c.
10	Payment of Expenses of Realization	Realization A/c .... Dr. To Cash/Bank A/c (if paid by the firm) or To Partner Cap. A/c (if paid by any partner)	If a partner bears such expenses personally in pursuance of a separate agreement - NO ENTRY is required.
11	Balance of Realization Account representing Profit or Loss on Realization.	Realization A/c .... Dr. To Partners Cap. A/c (Profit shared in Profit Sharing Ratio) or Partner's Cap. A/c .... Dr. To Realization A/c (Loss shared in Profit Sharing Ratio)	

(B) Settlement of Partners Due - Through Capital Accounts :

Item/Purpose		Entry	Special Points to be Noted
1	Prepare Capital Accounts with balance as per Balance Sheet before the dissolution.	By Balance b/d (Cr. balance) To Balance b/d (Dr. balance)	
2	Transfer of Current A/c, if any.	Partner's Current A/c .... Dr. To Partner's Cap. A/c (Credit Balance) or Partner's Cap. A/c .... Dr. To Partner's Current A/c (Debit Balance)	
3	Undistributed Profit, Reserve, Joint Life Policy Reserve, Investment Fluctuation Fund, Contingency Reserve etc. transfer.	Profit and Loss (Cr.) A/c .... Dr. or Any Reserve A/c .... Dr. To Partner's Capital A/cs (Profit sharing ratio)	
4	Undistributed Loss, Fictitious/Unrealizable Assets etc. transfer.	Partners Capital A/c .... Dr. To Profit and Loss (Dr.) A/c or To Fictitious Assets A/c (Profit Sharing Ratio)	Example of unrealizable Asset-Advertisment Supense A/c
5	Any loan taken from any partner.	Partner's Loan A/c .... Dr. To Cash/Bank A/c	U/s 48 Repayment of loan should enjoy priority over repayment of capital.

6	Any loan given from any partner.	Cash/Bank A/c .... Dr. To Partner's Loan A/c or Patner's Capital A/c .... Dr. To Partner's Loan A/c	If such amount is realized. Adjustment of loan against Capital
7	If any partner's Capital A/c shows a debit balance (after balancing)	Cash/Bank A/c .... Dr. To Particulars Partner's Capital A/c (Cash brought in to make up the shortfall)	If the deficient partner is insolvent, treatment will be different. Vide - insolvency of Partner.
8	Payment of credit balance (after final balancing)	Particulars Partner's Cap. A/c Dr. To Cash/Bank A/c	Same as above

Illustration 26

A, B and C sharing profits in 3 : 1 : 1 agree upon dissolution. They each decide to take over certain assets and liabilities and continue business separately.

Balance Sheet as on Date of Dissolution

Liabilities	Amount (Rs.)	Assets		Amount (Rs)
Creditors	6,000	Cash of Bank		3,200
Loan	1,500	Sundry Assets		17,000
Capitals :		Debtors	24,200	
A. 27,500		Less : Bad Debts Provision	1,200	23,000
B. 10,000		Stock		7,800
C. 7,500	44,500	Furnitures		1,000
	52,000			52,000

It is agreed as follows :

1. Goodwill is to be ignored.
2. A is to take over all the Fixtures at ₹ 800 : Debtors amounting to ₹ 20,000 at ₹ 17,200. The creditors of ₹ 6,000 to be assumed by A at the figure.
3. B is to take over all the stocks at ₹ 7,000 and certain of the sundry assets at ₹ 7,200 (being book value less 10%)
4. C is take over the remaining sundry assets at 90% of book values less ₹ 100 allowances and assume responsibility for the discharge of the loan, together with accruing interest of ₹ 30 which has not been recorded in the books of the firm.
5. The expenses of dissolution were ₹ 270. The remaining debtors were sold to a debt collecting agency for 50% of book values.

Prepare Realization Account, partners' Capital Accounts and Bank Account.

In The Books of A, B and C Realization Account

Dr. Particulars		Amount (₹)	Particulars		Cr. Amount (₹)
To Sundry Assets :			By Provision for bad debts		1,200
			Capital Account A :		
Sundry Assets	17,000		Fixtures	800	
Debtors	24,200		Debtors	17,200	
Stock	7,800				18,000
Fixtures	1,000		B : Stock	7,000	
		50,000	Sundry Assets	7,200	
					14,200
Bank - Expenses		270	C : Sundry Assets		8,000
Captial Account			By Bank : Collection from Debtors		2,100
C-Interest on Loan		30	By Loss on realization :		
			A (3/5)	4,080	
			B (1/5)	1,360	
			C (1/5)	1,360	6,800
		50,300			50,300

Capital Account

Dr. Particulars	A (₹)	B (₹)	C (₹)	Particulars	A (₹)	B (₹)	Cr. C (₹)
To Dissolution	18,000	14,200	8,000	By Balance b/d	27,500	10,000	7,000
Assets taken				Creditors	6,000	–	–
Dissolution A/c	4,080	1,360	1,360	Loan(with interest)	–	–	1,530
Loss				Bank			
Bank				Final receipts	–	5,560	830
Final Payment	11,420						
	33,500	15,560	9,360		33,500	15,560	9,360

Bank Account

Dr. Particulars		Amount (₹)	Particulars	Cr. Amount (₹)
To Balance b/d		3,200	By Dissolution Account	
Dissolution A/c			Expenses	270
Collection from Debtors		2,100	Capital Account :	
Capital Accounts :			A	11,420
B	5,560			
C	830	6,390		
		11,690		11,690

Working Notes : ₹

1. Realization of Sundry Assets :

Sundry Assets (Book Value)	17,000
Less : Taken by B [7,200 × (100/90)]	8,000
Remaining at book value	9,000

Taken by C : 90% of Book value

i.e. (9,000 × (90/100)) = 8,100 – 100 for allowance = 8,000

2. Collection from Debtors :

Debtors (Book Value)	24,200

Less : Taken by (Book Value) 20,000

4,200

Remaining of 50% i.e., ₹ 2,100

Illustration 27.

X, Y and Z sharing profits and Losses in the ratio of 2 : 2 : 1 agreed upon dissolution of their partnership on 31st December, 2012 on which date their Balance Sheet was as under :

Liabilities		Amount (₹)	Assets		Amount (₹)
Capital :			Fixed Assets		50,000
X		40,000	Joint Lift Policy (at surrender value)		10,000
Y		30,000			
Reserve Fund		10,000			
Joint Life Policy Fund		10,000	Debtors	10,000	
Creditors	19,000		Less : Provision for Bad Debts	500	9,500
Less : Prov	500				
Salay Outsanding		18,500			
		2,000	Stock of Invoice Price	10,000	
			Less : Price loading	2,000	8,000
			Investments	8,000	
			Less : Fluctuation Fund	500	7,500
					2,000
			Capital Account-Z		23,500
		1,10,500	Bank		1,10,500

Investment were taken over by X at ₹ 6,000, creditors of ₹ 10,000 were taken over by Y who has agreed to settle account with them at ₹ 9,900. Remaining creditor were paid ₹ 7,500. Joint Life Policy was surrendered and Fixed Assets realized ₹ 70,000. Stock and Debtor realized ₹ 7,000 and ₹ 9,000 respectively. One customer, whose account was written off as bad, now paid ₹ 800 which is not included in ₹ 9,000 mentioned above. There was on unrecorded asset estimated at ₹ 3000, half of which as handed over to an unrecorded liability of ₹ 5,000 in settlement of claim of ₹ 2,500 and the remaining half was sold in the market which realized ₹ 1,300.

Y took over the responsibility of completing the dissolution and he is granted a salary of ₹ 400 per month. Actual expenses amounted to ₹ 1,100. Dissolution was complete and final payments were made on 30th April, 2013.

You are required to prepare the Realization Account, Capital Account and Bank Account.

Sol. **Realization Account**

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Fixed Assets A/c		50,000	By Provision on Debtor A/c		500
To Joint Life Policy A/c		10,000	By Provision on Stock A/c		2,000
To Debtors A/c		10,000	By Investment Fluctuation		
To Stock (at I.P.)		10,000	Fund A/c		500
To Investments A/c		8,000	By Joint Life Policy Fund A/c		10,000
To Pro. For Disc. On		500	By Creditors A/c		19,000
Creditors A/c			By Outstanding Salary A/c		2,000
To Y's Capital A/c		10,000	By X Capital A/c		6,000
(Creditors taken			(Investments taken over)		
over - see Note)			By Bank A/c :		
To Bank A/c			Joint Life Policy	10,000	
Creditors paid off	7,500		Fixed Assets	70,000	
Unrecoreded liability	2,500		Stock	7,000	
paid (1/2 × 5,000)			Debtors	9,800	
Outstanding Salary	2,000		Unrecorded Assets (Sold)	1,300	
Outstanding Expenses	1,100	13,100	Bad Debt Recovered	800	98,100
To Y's Cap. A/c		1,600			
(Salary 400 × 4)					
To Partner's Capital A/c					
(Profit on Realization)					
X(2/5)	9,960				
Y(2/5)	9,960				
Z(2/5)	4,980	24,900			
		1,38,100			1,38,100

Bank Account

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/f	23,500	By Realization A/c	
To Realization A/c		Creditors	7,500
Joint Life Policy	10,000	Unrecording Liability	2,500
Fixed Assets	70,000	Outstanding Salary	2,000
Stock	7,000	Expenses	1,100
Debtors	9,800	By X's Capital A/c	47,960
Unrecorded Assets	1,300	By Y's Capital A/c	55,560
		By Z's Capital A/c	4,980
	1,21,600		1,21,601

Partners Capital Account

Dr.									Cr.
Date 2013	**Particulars**	**X (₹)**	**Y (₹)**	**Z (₹)**	**Date 2013**	**Particulars**	**X (₹)**	**Y (₹)**	**Z (₹)**
1 . 1	To Balance b/d	–	–	2,000	1 . 1	To Balance b/d	40,000	30,000	–
30.4	To Realization A/c	6,000	–	–	30.4	By Reserve Fund (2:2:1)	4,000	4,000	2,000
	To Bank A/c (Balance Withdrawn)	47,960	55,560	4,980		By Realization A/c (Profit)	9,960	9,960	4,980
						By Realization A/c (Creditors)	–	10,000	–
						By Realization A/c (Salary)	–	1,600	–
		53,960	55,560	6,980			53,960	55,560	6,980

Note :

1. Unrecorded Asset and unrecorded liability were not recorded. Any part of such asset utilized to discharge any part of such liability and discount received there on have been ignored.

   But unrecorded asset realized (debts previously written of now recovered) has been recorded. Similarly unrecorded asset sold has been recorded.

2. Y took over creditors of ₹ 10,000. This has been recorded. How he settles such liability is his personal matter. The discount on payment does not benefit the firm.

Special considerations for a retiring partner and the estate of a deceased partner in relation to debts contracted by the partnership firm :

(a) **Debts due on the Date of Retirement/Death :** The retiring partner and the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death, to the external of their share.

(b) **Debts Incurred After Retirements :** Where the notice of retirement is not published in accordance with law, the retiring partner is liable for debts contracted after retirement.

(c) **Deceased/Insolvent Partner :** The estate of a deceased or bankrupt partner will not be liable for debts contracted by the firm after the death or bankruptcy.

Applicability of Section 37 of the Partnership Act

In case of retirement, the retiring partner or in case of death, the executor of the deceased partner, if the dues are not settled, then such retired partner or the executor is entitled to the following :

Maximum of : Interest @ 6% p.a. on the amount due to them (i.e. if the amount is unsettled, like, rate of interest on loan to be allowed to the retired partner or the executor is not mentioned)

or

The share of profit earned for the amount due to the partner

Conditions :

(a) The surviving partners/continuing partners continue to carry on the business of the firm.

(b) The business is carried on without any final settlement of accounts between the continuing partners and the outgoing partners or his estate.

(c) There is no contract to the contrary of the options contained Section 37 i.e. share in the profits or interest @ 6% p.a. on the unsettled capital.

Example : Unsettled capital of C ₹ 52.000 (Date of retirement : 30.9.12, financial year 2012-13). Net Profit earned by the firm after C's retirement ₹ 25,000. Capitals of A : ₹ 57,000 and B : ₹ 76,000) C is entitled to the maximum of the following :

(i) Interest on unsettled capital = ₹ 52,000 × 6% × 6 months = ₹ 1,560

(ii) Profit earned out of unsettled capital = Profit x Retired or Deceased Partner's unsettled Dues/ Total Capital of the firm (including the amount due to the retired or deceased partner)

= ₹ (25,000 × 52,000)/(₹ 52,000 + 57,000 + 76,000) = ₹ 7,027.

2.2.6 Insolvency of a Partner

If a partner becomes insolvent and fails to pay his debit balance of Capital A/c either wholly or in part, the unrecoverable portion is a loss to be borne by the solvent partners. The question now arises is that, in what ratio they will share this loss. Prior to the decision in the leading case of Garner vs. Murray this loss was borne by the solvent partners in the profit sharing ratio just like ordinary losses.

Decision in Garner vs. Murray Case

Justice Joyee held in the case of Garner vs. Murray that the loss arising due to the insolvency of a partner must be distinguished from an ordinary loss (including realization loss). Unless otherwise agreed, the decision in Garner vs. Murray requires :

(i) That the solvent partners should bring in cash equal to their respective shares of the loss on realization;

(ii) That the solvent partners should bear the loss arising due to the insolvency of a partner in the ratio of their Last Agreed Capitals.

In case of fixed capital system, capitals as per last Balance Sheet represent last agreed capitals. In case of fluctuating capital system, however, all necessary adjustments in respect of reserved. Unappropriated losses (but not realization profit or loss), Drawings A/c.. undisclosed liabilities and assets etc. must be made to get last agreed capitals. A partner who has nil or negative balance in his capital account before dissolution does not contribute anything to the loss arising as a result of insolvency of a partner.

Criticism of the decision of Garner vs. Murray

The following criticism may be advocated against the decisions laid down in Garner vs. Murray principle :

(i) If any solvent partner has a debit balance in capital account, he must not bear the deficiency of the insolvent partner;

(ii) This principle does not apply if there are only two partners;

(iii) In spite of having a credit balance in capital account the solvent partner must bring cash equal to the amount of loss on realization which is immaterial and useless; and

(iv) If any solvent partner who possess more private asset but contributes less capital, he will naturally, as per Garner vs. Murray decision, bear less amount of deficiency of the insolvent partner than the other solvent partner who possess less private assets but contributes more capital to the firm. This is not justified.

Applicability in India

According to sub section (ii) of Sec 48(b) of the Indian Partnership Act, if a partner becomes insolvent or otherwise incapable of paying his share of the contribution, the solvent partners must share ratably the available assets (including their own contribution to the capital deficiency). That is to say, the available assets will be distributed in proportion to their capitals.

Thus, under the Indian Partnership Act also the solvent partners are required to make good their share of the realization loss (i.e., capital deficiency). The total cash available after making good the solvent partners' share of capital deficiency shall be shared by the solvent partners in proportion to their capitals. As a result of this the ultimate debit balance of the insolvent partner's Capital A/c. is borne by the solvent partners in capital ratio.

The provision of the Indian Partnership Act in this respect are, thus, similar to the rules laid down by the decision in Garner vs. Murray.

When there is a specific provision in the Partnership Deed as to how the deficiency of an insolvent partner is to be borne by the solvent partners, such provision must be followed, because the provision of the Act will apply only when there is no specific agreement.

Illustration 28.

A. B and C are in partnership sharing profit and losses equally and agreed to dissolve the firm on 30.06.2012. On that date their Balance Sheet stood as follows :

Balance Sheet as at 30th June, 2013

Liabilities		Amount (₹)	Liabilities	Amount (₹)
Capital A/c			Sundry Asset	50,000
A	34,000		Profit and Loss A/c	12,000
B	24,000	58,000	Capital Account	
Creditors		12,000	C	8,000
		70,000		70,000

The assets are realized at 50% of the book value. Realization expenses amounted to ₹ 5,000. C become insolvent and received ₹ 2,000 from his estates.

Close the book of the firm under (i) Fixed Capital Method and (ii) Fluctuating Capital Method applying Gamer vs. Murray principles.

Sol.

In the Book of A, B and C

Dr. **Cr.**

Liabilities	Amount (₹)	Liabilities		Amount (₹)
To Sundry Asset A/c	50,000	By Bank A/c		
Bank A/c		Amount Realised		25,000
Expense	5,000	Capital A/c		
		Loss on Realization		
		A	10,000	
		B	10,000	
		C	10,000	30,000
	55,000			55,000

Working :

(a) **Under Fixed Capital Method :** Deficiency of the insolvent partner Mr. C must be bome by the solvent partner A and B as per their last agreed capital given in the Balance Sheet i.e., 17 : 12.

(b) **Under Fluctuating Capital Method :** Deficiency of the insolvent partner Mr. C must be bome by the solvent partners A and B as the following adjusted capital which will be considered as the last agreed capital i.e., after adjusting the debit balance of Profit and Loss Account.

Particulars	A (₹)	B (₹)
Capital as per Balance Sheet	34,000	24,000
Less : Debit balance of P & L A/c (equally)	(-) 4,000	(-) 4,000
	30,000	20,000

∴ Ratio = 3 : 2

(a) Capital Account under Fixed Capital Method

Capital Account

Dr. Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹) Cr.
To Balance b/c	–	–	8,000	By Balance b/d	34,000	24,000	–
Realisation A/c				Bank A/c	–	–	2,000
Loss	10,000	10,000	10,000	Bank A/c	10,000	10,000	–
Profit and Loss A/c				A's A/c	–	–	11,724
Loss	4,000	4,000	4,000	B's A/c	–	–	8,276
C's Capital A/c	11,724	8,276	–				
Bank A/c	18,276	11,724	–				
(bal. fig.)							
	44,000	34,000	22,000		44,000	34,000	22,000

Bank Account

Dr. Particulars		Amount (₹)	Particulars	Amount (₹) Cr.
To Balance b/d		25,000	By Realisation A/c	
Capital A/c			Expenses	5,000
A	10,000		Creditors	12,000
B	10,000		Capital A/c	
C	2,000		A	18,276
		22,000	B	11,724
		47,000		47,000

(b) Under Fluctuating Capital Method

Capital Account

Dr. Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹) Cr.
To Balance b/c	–	–	8,000	By Balance b/d	34,000	24,000	–
Realisation A/c				Bank A/c	10,000	10,000	–
Loss	10,000	10,000	10,000	Bank A/c	–	–	2,000
Profit and Loss A/c				A's A/c	–	–	12,000
Loss	4,000	4,000	4,000	B's A/c	–	–	8,000
C's Capital A/c	12,000	8,000	–				
Bank A/c	18,000	12,000	–				
(bal. fig.)							
	44,000	34,000	22,000		44,000	34,000	22,000

Bank Account

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	25,000	By Realisation A/c	
Assets Realised		Expenses	5,000
Capital A/c		Creditors	12,000
A	10,000	Capital A/c	
B	10,000	A	18,000
C	2,000	B	12,000
	47,000		47,000

If all The Partners are Insolvent

Since all partners are insolvent, creditors cannot expect to be paid in full. In such a case Sundry Creditors should not be transferred to Realization Account. Cash in hand together with the amount realized on sale of assets and surplus from private estate of partners, if any, less expenses will be applied in making payment to the creditors. The balance of Creditors Account represents the deficiency to be borne by them which to be transferred to a Deficiency Account. The balance of Capital Accounts should also to be transferred to the Deficiency Account to close the books. Alternatively, the deficiency to be borne by the Creditors may be directly adjusted in between Creditors Account and Capital Accounts.

The following entries required to be passed :

(i) To pay-off the creditors

Creditors A/c	Dr.	(Total Creditors)
To Bank A/c		(Amount paid)
To Deficiency A/c		(Amount unpaid)

(ii) When deficiency is transferred

Deficiency A/c	Dr.
To Partners' Capital A/c	

Return of Premium to a Partner on Dissolution before Expiry of Term

Conditions :

(i) A partner was admitted in the partnership firm for a fixed term period,

(ii) Such partner had paid a premium for goodwill at the time of admission.

(iii) The partnership firm has dissolved.

Exceptions : The partner will not be entitled to any claim under any of the following conditions :

(i) The firm is dissolved due to death of a partner

(ii) The dissolution is due to the misconduct of the partner claiming refund

(iii) Dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

Piecemeal Distribution

Till now the discussion was based on the implicit assumption that all assets were realized and settlement was done on the same date. In fact, on the dissolution of a partnership, assets are sometimes realized gradually over a period of time. In such a case it may be agreed that different parties are to be paid in order of preference as and when assets are realized without unnecessarily waiting for the final realization of all the assets.

The order of the payment will be as follows :

(i) Realization expenses

(ii) For provision for expenses that are to be made

(iii) Preferential creditors (say, Income Tax or any payment made to the Government)

(iv) Secured creditors – upto the amount realized from the disposal of assets by which they are secured and for the balance, if any, to be paid to unsecured creditors

(v) Unsecured creditors – in proportion to the amount of debts, if more than one creditor

(vi) Partners' loan – if there is more than one partner – in that Case, in proportion to the amount of loan

(vii) Partners' capital – the order of payment may be made by any one of the following two methods :

  (a) Surplus Capital Method/ Proportionate Capital Method/ Highest Relative Capital Method

  (b) Maximum Possible Loss Method

Surplus Capital Method/Proportionate Capital Method/Highest Relative Capital Method

Under this method, actual capital of the partners on the date of dissolution is compared with their proportionate capital (determined on the basis of minimum capital per unit of profit) to determine surplus capital of the partners. Surplus capital is paid first and any balance left thereafter is distributed in the profit sharing ratio. This ensures that final balances of partners show their share of realization profit/loss and thus, no settlement need to be dome at that point of time.